DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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APR 2 1 2005

MEMORANDUM FOR MARK O'DONNELL
ACTING DIRECTOR, EMPLOYEE PLANS RULINGS AND AGREEMENTS

FROM: Michael J. Roach
Manager, CC:TEGE:EB:QP1

SUBJECT: Request for Assistance (Valuation of 401(k) account balances in an Offer in Compromise)

This memorandum has been prepared in response to Paul T. Schultz's e-mail request, dated February 16, 2005, to our office requesting that we comment on an issue raised by Mark J. Miller, Associate Area Counsel (SBSE), Milwaukee, regarding the valuation of 401(k) account balances for purposes of evaluating a taxpayer's offer in compromise.

**Issue**

How is an account balance in a 401(k) plan valued for purposes of an offer in compromise?

**Facts**

Taxpayer has submitted an offer in compromise. Taxpayer participates in a 401(k) plan and has a current account balance of $[redacted] Taxpayer has no current distribution rights to her account balance unless she severs employment. However, she could borrow $[redacted] from the account. Taxpayer is 52 years old.

Revenue officer's analysis and National Office advice

The revenue officer valued the account at $[redacted] Area Counsel returned the offer questioning the value placed on the account, citing IRM 5.8.5.3.8 and IRM 5.8.5.3.8(4) for the proposition that a 401(k) for a taxpayer not close to retirement is to be valued by using the cash value of the account less any expenses for liquidating the account and early withdrawal penalty. Area Counsel believes this results in the 401(k) account having a value greater than $[redacted]

The revenue officer advised Area Counsel that her group had sought informal advice from the National Office in a similar case. In that case, the taxpayer had a 401(k) account, but had no right to the funds until severance from employment. In addition, there was no right to borrow against the account. The National Office advised that since there was no right to withdraw funds

from the 401(k) until severance, the 401(k) had no value for offer purposes.

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- LaSalle National Bank v. United States, 636 F.Supp. 874 (N.D.Ill. 1986). The taxpayer was the beneficiary of a testamentary trust. The taxpayer was delinquent with respect to his federal taxes, and the federal government served a notice of levy on LaSalle National Bank, the trustee for the taxpayer's trust. The taxpayer argued that (1) his interest in the trust did not constitute property or the right to property under state law and therefore was not subject to levy; and (2) that Illinois law prohibits a creditor from attaching the property held in a trust that is established in good faith by a third party. The court found that Illinois law treated an equitable fee interest in a trust as a property right, and that it is settled law that once a court finds that the taxpayer has property or a right to property in a trust under state law, any state law is inoperative to prevent attachment of a lien created by federal statutes.

- United States v. Southwestern Life Insurance Company, 526 F.Supp. 62 (N.D.Tex. 1981). Taxpayer was the sole shareholder of an incorporated medical practice. The corporation established a defined benefit pension plan, in which

[1] *See* In re McIntyre, 222 F.3d 655, 660 (9th Cir. 2000).
[redacted] the following cases regarding the Service's ability to immediately levy against the income and/or assets of a spendthrift trust: La Salle National Bank v. United States, 636 F.Supp. 874 (N.D. Ill. 1986); United States v. Riggs National Bank, 636 F. Supp. 172 (D.D.C. 1986); Bank One Ohio Trust Co. v. United States, 80 F.3d 173 (6th Cir. 1980); Mercantile Trust v. Hoffer, 58 F. Supp. 701 (D. Md. 1944). None of these cases involve the levy of retirement plan assets.

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taxpayer and his wife were the only participants and for which they served, in addition to their son, as trustees. The trust for the plan held annuity contracts that had significant cash surrender values. The federal government filed a notice of tax levy on the issuer of the annuity contracts seeking to levy against the contracts for unpaid federal tax obligations. The government argued that the annuity contracts were subject to levy because of the taxpayers' beneficial interest in the plan's trust, their effective control of the trust as trustee and sole beneficiaries, and their control of the employer that sponsored the plan that established the trust. The court observed that whether a taxpayer has an interest in property for purposes of federal taxation is a question of state law. The court found that the anti-alienation provisions of the plan's trust as required under section 401(a)(13) were a classic spendthrift trust under Texas law, and that Texas law does not recognize a spendthrift trust in which the settlor is also the beneficiary (and thus the beneficiary is treated as owning the trust's assets for purposes of creditors rights). While the court noted that the corporate plan sponsor was technically the settlor of the plan, the court ruled that the annuities were subject to levy because "it strains reality to argue that [the taxpayer] was not the settlor of the trust in question." There is no discussion of whether the participants had immediate distribution rights with respect to their vested interests in the plan and whether such rights would have changed the result.

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The provisions of the IRM cited above are attached to this memorandum.

**Discussion**

Ability of the Service to levy on a 401(k) plan that is not in pay status

Few cases have been found that address whether a levy may be immediately enforced against a participant's interest in a section 401(a) qualified plan if the plan does not permit immediate distribution:[3]

[3] Area Counsel cites to a number of cases for the proposition that the Service may immediately levy against a plan even if the participant does not have current distribution rights, specifically: United States v. Sawaf, 74 F.3d 119 (6h Cir. 1996) (federal garnishment of ERISA pension plan); Iannone v. Commissioner, 122 T.C. 287 (2004) (401(k) account); IBEW v. Forman, 95-2 U.S.T.C. 50,601 (D.Ariz. 1995) (pension benefits); In re Jones, 206 B.R. 614 (Bankr. D.C. 1997) (federal employee's TSP retirement account); O'Connell v. United States, 1997 Bankr. Lexis 1340 ( Bankr. S.D. Fla. 1997) (401(k) account); Farr v. United Airlines, 81 A.F.T.R. 2d 2258, 1998 U.S. App. Lexis 10753 (9th Cir. 1998) (involving a levy on a 401(k) plan); In re McIntyre, 222 F.3d 655 (9th Cir. 2000) (retirement plan); United States v. Southwestern Life Insurance Co., 526 F. Supp. 62 (N.D. Tex. 1981) (pension

- Internal Revenue Service v. Snyder. 343 F.3d 1171 (9th Cir. 2003). The Service argued that the United States was a secured creditor in the debtor's bankruptcy proceeding to the extent of the federal tax lien that attached to the debtor's interest in a tax-qualified retirement plan. At the time of the bankruptcy proceeding, the debtor did not have a right to a distribution from the plan. The Ninth Circuit Court of Appeals ruled against the Service. In explaining the consequences of the Service's status as a secured creditor, the Ninth Circuit rejects the district court's conclusion that the Service could have immediately levied on the debtor's interest in the retirement plan:

  > . . . if Snyder's bankruptcy plan is confirmed by the bankruptcy court, Snyder would have to make full payment of the IRS's secured claim during the life of the bankruptcy plan. See 11 U.S.C. § 1325(a)(5)(B)(ii) (stating that a plan shall be confirmed if "with respect to each allowed secured claim . . . the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim"). In that event, the IRS would get in bankruptcy a payment for which it would otherwise have had to wait. The wait would otherwise have been required because the IRS cannot, outside of bankruptcy, enforce its liens on Snyder's interest in his ERISA plan until the plan enters pay-out status. Snyder has no right to demand payment from the plan trustee until that time, and it is a familiar maxim that the IRS merely steps into the shoes of the taxpayer and does not acquire any greater rights to property than the taxpayer himself enjoys. *See* United States v. Nat'l Bank of Commerce, 472 U.S. 713, 725, 105 S.Ct. 2919, 86 L.Ed.2d 565 (1985).

- The bankruptcy court in Snyder had held that in the case of a federal tax lien filed against a debtor, the debtor's interest in an ERISA-qualified retirement plan was property of the Chapter 13 estate, and thus the Service's claim for unpaid federal taxes was secured to the extent of the debtor's interest in the plan. In appealing this decision to the district court, the debtor argued that such a holding was inconsistent with the Supreme Court's decision in Patterson. In upholding the lower court's decision, the district court reasoned that federal tax lien and levy law is "applicable nonbankruptcy law" which overrides ERISA's general anti-alienation rule, and thus the debtor's interest in an ERISA-qualified plan is property of the estate for purposes of determining the Service's status as a secured creditor. 285 B.R. 712 (N.D.Cal. 2002).

  In the district court proceeding, the debtor conceded that a tax lien properly

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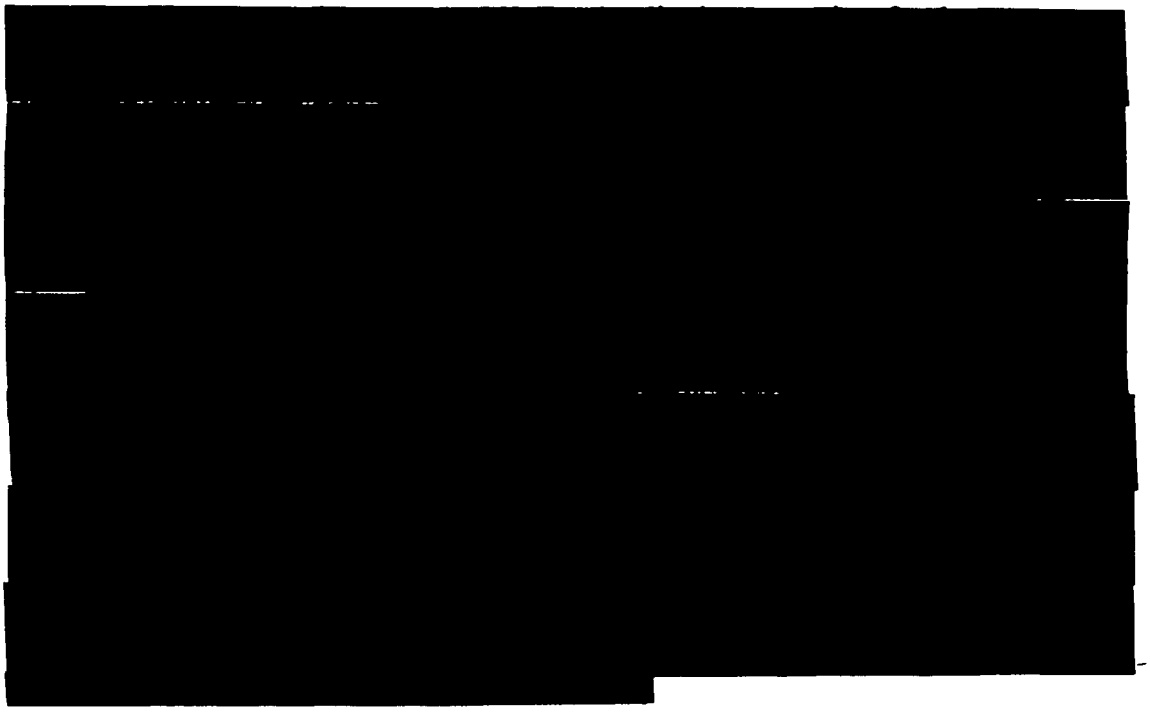
plan). In each of the cases, however, it is either clear that the participant has current distribution rights (i.e., the plan is in pay status) or this fact is not addressed at all, and in any event, there is no discussion of the impact of the participant's distribution rights on the ability of the Service to levy against the plan.

attached to his interest in the plan, but argued that the Service could not be a secured creditor because no levy was possible since the plan was not in pay status. The district court disagreed:

> As mentioned earlier, the IRS has the right to enforce liens against interests in ERISA pensions by means of levy, as long as the interest in the plan does not fit an exemption under 26 U.S.C. § 6334. *See* 26 C.F.R. § 1.401(a)-13(b)(2); In re McIntyre, 222 F.3d 655, 660 (9th Cir. 2000) ("ERISA's anti-alienation clause cannot prevent the IRS from undertaking what would otherwise be a valid exercise of its levy authority under 26 U.S.C. § 6331"). This broad right to levy is applicable to unmatured ERISA plans, because the vested right to a future payment is "property" subject to levy and amenable to present valuation. *See* Perkins, 134 B.R. at 411-12; In re Schaffer, 1997 WL 580786, 1997 Bankr. LEXIS 841, *7 (Bankr.D.Idaho 1997); Jones, 206 B.R. at 617. Even if the levy power has not been exercised, an [sic] federal tax lien is enforceable outside of the bankruptcy context in order to ensure priority of the potential exercise of the IRS' right to levy. Jones, 206 B.R. at 617. Snyder does not argue that his interest in the Plan is exempt from levy under § 6334(a). Therefore, Snyder's argument that the IRS is not a secured creditor because it could not levy his interest in the Plan is meritless.



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- In re Schaffer, 1997 Bankr. LEXIS 841, *7 (Bankr.D.Idaho 1997). The bankruptcy court held that the Service may levy against a section 401(k) account,

but deferred to the Service as to whether the levy could be made immediately if the account was not in pay status:

> The timing of the Service's collection efforts is a matter of internal policy. This court has determined the Service's right to collect from the interest of the Debtors in the 401k plans. The extent of the Debtors' interest in the plans is controlled by the provisions of the plans. Debtors have submitted no evidence of the terms of the plans in question that determine the extent and nature of their interest. Thus, this Court cannot speculate as to the tax consequences of the levy on the Debtors' 401k plans within the context of this adversary proceeding.

At *7-*8.

In analyzing whether a 401(k) account balance could be subject to a levy, the Schaffer court reasoned that the account balance was a property interest under applicable state law and Code § 6334 did not exempt the plan from levy. The court noted that ERISA's anti-alienation provision did not alter this result. The case was not appealed and has only been cited by the district court opinion in Snyder.

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Few administrative decisions have been issued by the Service addressing this issue:

- PLR 200426027 concludes that a levy cannot reach a participant's right in a pension plan unless the right is in pay status, citing to cases addressing levies against non-pension plan bank accounts (National Bank of Commerce and United States v. Sterling Nat'l Bank, 494 F.2d 919, 922 (2nd Cir. 1974)) for the proposition that in a levy proceeding the IRS steps into the taxpayer's shoes and acquires whatever rights the taxpayer himself possesses.

- A 1988 General Litigation Bulletin, 1988 GLB LEXIS 6, could be interpreted as possibly concluding that a 401(k) plan that is not in pay status may be levied. The discussion and conclusion in the bulletin are ambiguous. The cases cited in the bulletin's discussion are not pension cases (the cases deal with levies against testamentary trusts and alimony payments).

Conditional nature of plan loans

In order for a plan loan[4] to qualify for the regulatory exemption from the prohibited transaction rules (which is necessary, because without the exemption, the plan could not permit a plan loan), loans under the plan's plan loan program must be available to all plan participants on a reasonably equivalent basis. DOL Reg. § 2550.408b-1(a)(1)(i). Despite this requirement, a participant in a retirement plan that permits plan loans does not have an absolute right to such a loan. Thus, an offer in compromise may properly take into account the value of a plan loan from a 401(k) account only to the extent that the debtor actually is able to obtain the loan.

For example, the regulations imply that conditions on the use of loan proceeds are permissible since the regulations indicate that such conditions are not per se unreasonable (although such conditions do raise issues of whether the loan program is available on a reasonably equivalent basis). DOL Reg. § 2550.408b-1(a)(4)(Ex. 8).

Additionally, in order to meet the "reasonably equivalent basis requirement", the DOL regulation requires satisfaction of the following standard: "In making such loans, consideration has been given ***only*** to those factors which would be considered in a normal commercial setting by an entity in the business of making similar types of loans. Such factors include the applicant's creditworthiness and financial need." DOL Reg. § 2550.408b-1(b)(1)(ii) (emphasis added). Thus, it is clear that the regulation contemplates that under some circumstances a participant may be denied a plan loan. For example, the DOL regulations require that a plan loan must be adequately secured and bear a reasonable rate of interest. DOL Reg. § 2550.408b-1(a)(1)(iv), (v). The regulations specifically state that if the terms of the loan program prohibit charging a reasonable rate of interest (e.g., the rate would violate local usury laws), then the plan loan may not be granted. DOL Reg. § 2550.408b-1(d)(Ex. 3).

**Conclusion**

We believe that the Service's ability to levy against a 401(k) plan is probably limited to the extent of the taxpayer's distribution rights under the terms of the plan. Accordingly, to the extent that the evaluation of an offer in compromise is dependent on the extent of the Service's ability to levy against a taxpayer's interest in a 401(k) plan, the offer in compromise probably should not take into account a 401(k) plan account balance unless the taxpayer has a right to a distribution from the plan within the payment period of the offer in compromise. With respect to the ability of the taxpayer to borrow against his or her account balance in a 401(k) plan, we

[4] The term "plan loan" refers to a loan to a participant from the participant's interest in a retirement plan.

believe that if the taxpayer can in fact borrow against the account balance, the offer in compromise should take into account the amount that the taxpayer could borrow from the account.

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If you have any questions or comments regarding this memorandum, please contact me at 202-622-8099 or Drew Crouch at 202-622-7294.